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Fed will likely signal that the 25bp cut will not be a one-off

Javier Amador, Iván Fernández

The dot plot is set to reflect a dovish shift, but officials are likely to remain cautious as inflation risks continue to cloud the outlook

Incoming activity data since the last meeting continued to point to modest underlying growth, with consumption and investment holding up despite persistent headwinds. The second estimate of Q2 GDP showed a revision up to 3.3% annualized, from the initial 3.0%. The sharp rebound from the -0.5% contraction in Q1 was primarily driven by a strong positive contribution from net exports. However, the underlying momentum remained modest, with private consumption and tech-related investment driving final sales to private domestic purchasers to match Q1's 1.9% pace, well below last year's average (Figure 1). Available indicators suggest such resilience extended through Q3, with real personal spending rising by 0.3% m/m in July, supported by motor vehicle sales. Business equipment investment also benefited from further growth in capital goods imports, particularly computers and telecommunications equipment. The Atlanta Fed's GDPNow model currently projects Q3 growth at 3.1% annualized. Survey data suggest that the services sector is leading the recovery, with the ISM services index climbing to a six-month high in August, while manufacturing remains subdued, albeit with tentative signs of stabilization in new orders. Altogether, the picture remains one of a resilient economy showing signs of slowing momentum, but increasingly exposed to downside risks as recent labor market data point to emerging weakness.

The latest jobs data upended the story of a solid labor market and erased any chance of the Fed further delaying rate cuts, even as inflation risks persist. The most significant shift came with the July employment data, which showed a 73,000 gain for the month but included downward revisions to May and June's payrolls of more than 100,000 each—to just 19,000 and 14,000, respectively—triggering a significant reassessment of labor market strength across markets and forecasters. The August release reinforced that trend, with just 22,000 new jobs and an additional downward revision to June showing a 13,000 decline—the first monthly job loss since 2020—bringing the three-month average to a mere 29,000, including a modest 6,000 upward revision to July (Figure 2). Compounding the labor market outlook deterioration, the BLS's preliminary benchmark revision suggests payroll employment in the year through March 2025 will be revised down by 911,000, pointing to a much weaker labor market than previously assumed. Meanwhile, JOLTS data for July revealed a further decline in job openings to a 10-month low and a stable quits rate of 2.2%, both signaling weaker hiring dynamics and reduced wage pressure going forward. Although layoffs remain low and the unemployment rate (4.3%) is still within a historically normal range, the breadth and persistence of the slowdown suggest that labor demand is softening across most sectors. The ongoing immigration crackdown is also preventing the labor force from expanding, helping keep the unemployment rate from rising more sharply. At this point, it is hard to imagine anyone in the FOMC still defending the idea of a healthy labor market—despite that view seemingly being the dominant one as recently as July.

Inflation data continued to indicate that the pass-through from tariffs to consumer prices remains limited for now, but uncertainty over their full impact persists. The August CPI report showed a modest upside surprise, with headline inflation rising 0.4% m/m and core CPI up 0.35% m/m to 3.1% y/y (Figure 3), driven by a 0.4% m/m rise in rent of shelter and increases in goods categories more exposed to trade, such as vehicles (0.5%, the highest since January), apparel (0.5%), and personal care products (0.4%). That said, prices for medical (-0.3%) and tech-related goods (-0.3%) continued to ease, offsetting part of the increase in core goods inflation. July's PCE data echoed this composition: the full 0.27% m/m rise in the core price index came from services, while core goods prices were flat. On the producer side, the 0.1% m/m decline in the August core PPI was mostly due to a reversal of retailers' and wholesalers' margins, but underlying inflation pressures excluding those effects held at 0.3% m/m. Price subindices in the ISM PMIs remain elevated—particularly in services, where the index held near 70 in August. While there has been some easing, the data suggest lingering risks of tariff effects spilling over beyond goods, leaving the risk of second-round inflation pressures in place. With downside risks to employment rising, the Fed may no longer have the luxury of waiting for complete clarity before acting. At the same time, most officials are unlikely to conclude that tariff-related inflation risks have fully receded.

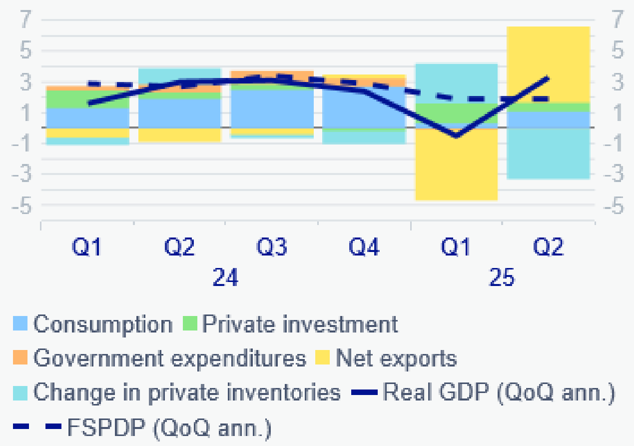
At one point during last week, the futures market assigned a 10% chance to a 50bp cut—though that likelihood declined to around 3% by the end of the week. Yields at the short end of the curve adjusted accordingly following the recent jobs data, with the 2-year Treasury falling by c. 40 bps since late July. Longer-term yields have also declined recently, but remain at levels that keep term premia elevated despite a lack of strong growth prospects. Instead, they are likely reflecting an increased premium for fiscal and institutional risk (Figure 4). Breakeven inflation rates had edged higher in July, but the recent reversal makes it unlikely that the Fed will view them as a sign of de-anchoring inflation expectations. The July FOMC minutes were quickly overshadowed by the subsequent jobs report. At the time of the meeting, most participants still judged that the economy was "at or near maximum employment" and "generally expected inflation to increase in the near term." Only "a couple of participants" highlighted downside risks to employment—a clear reference to Waller and Bowman, who dissented in favor of a 25bp cut instead of a pause. Since then, strong evidence of subdued labor demand has shifted the balance of risks, and Chair Powell's dovish remarks at Jackson Hole paved the way for a September cut, where he noted that "the shifting balance of risks may warrant adjusting our policy stance."

With downside risks to the full employment goal rising, we expect the Fed to cut rates by 25 bps to 4.00-4.25%. The statement and Powell's press conference will likely stress mounting downside risks to employment offsetting lingering uncertainty over tariff-related inflation. Alongside the decision, the Fed will release updated economic projections. We expect the new

SEP to show slightly stronger growth in 2025 and a modest upward revision to near-term inflation. The Fed might keep its 4.5% unemployment rate projection for year-end unchanged despite growing evidence of labor market weakness, justified by the lack of labor force growth amid tighter immigration policies. With a 25bp cut widely expected, the key question is whether the Fed will frame it as a fine-tuning of its current moderately restrictive stance or as a renewed easing cycle toward a more neutral stance. With the Fed now likely seeing risks to both goals as more balanced, it is likely to conclude that policy should no longer be restrictive and signal that this week's rate cut will not be a one-off. While some dissent in favor of a jumbo 50bp cut cannot be ruled out, we anticipate that a clear majority will support a 25bp rate cut.

Final sales to private domestic purchasers matched Q1's pace, below last year's average

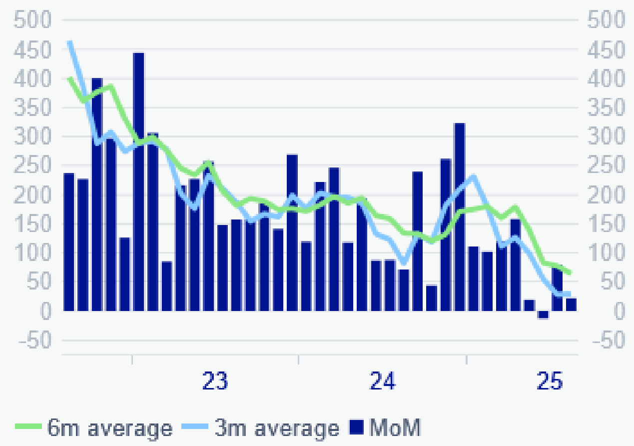
FIGURE 1. REAL GDP GROWTH (%)



Source: BBVA Research / BEA

The August report showed a 13,000 payrolls decline in June—the first job loss since 2020

FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research / BLS

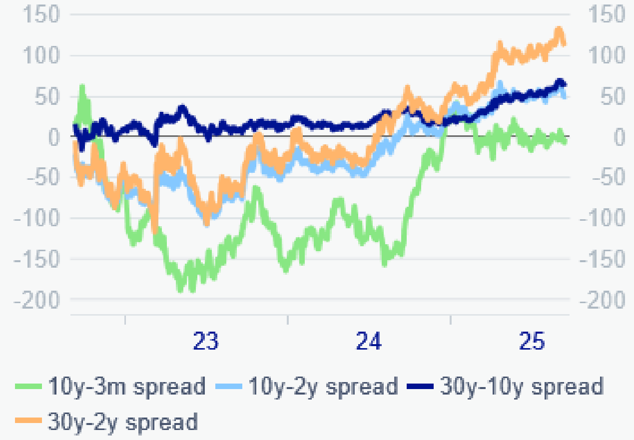
Core CPI inched up by 0.35% m/m to 3.1% y/y in August led by a 0.4% rise in rent of shelter

FIGURE 3. CORE CPI INFLATION (%)

Source: BBVA Research / BLS

Elevated long-term yields are likely reflecting a premium for fiscal and institutional risk

FIGURE 4. TREASURY YIELD SPREADS (%)



Source: BBVA Research / NBER / Treasury Dept.

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